MARATHON OIL CO.

IBLA 95-525 Decided July 2, 1999

Appeal from a decision of Associate Director for Policy and Management Improvement, Minerals Management Service, denying appeal from an order requiring payment of additional royalties with respect to gathering cost reimbursements. MMS-92-0084-O&G.

Affirmed.

1. Federal Oil and Gas Royalty Management Act of 1982: Royalties--Oil and Gas Leases: Royalties: Generally

When a Federal oil and gas lessee sells crude oil to its affiliate, and the affiliate exchanges the oil with a third party, the gathering costs included in a differential allowed to the affiliate by the third party are properly considered part of the lessee's gross proceeds from the sale of the oil.

APPEARANCES: Richard J. Kolencik, Esq., Marathon Oil Company, Findlay, Ohio; Howard W. Chalker, Esq. and Geoffrey Heath, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE KELLY

The Marathon Oil Company (Marathon/Appellant) has appealed from a February 28, 1995, decision of the Associate Director for Policy and Management Improvement, Minerals Management Service (MMS), denying its appeal from a January 14, 1992, Order of the Lakewood Area Compliance Office (LACO), Royalty Management Program, MMS. The Order required Marathon to pay additional royalties of $30,908.05 with respect to payments made to Marathon Petroleum Company (MPC), a Marathon affiliate, as reimbursement for gathering costs in connection with onshore oil production allocated to Federal oil and gas lease Nos. 064-043977-A, 064-043977-B, and 064-064294-0 during the period from March 1, 1986, to May 31, 1987. The Order also directed Marathon to perform specified restructured accounting with respect to some or all of its Federal and Indian oil and gas leases, pertaining to gathering costs and other reimbursements, and to pay any additional royalties found to be due.

The crude oil at issue was sold by Marathon during the period from March 1, 1986, to September 30, 1989, to its wholly-owned subsidiary and affiliate, MPC, under a nonarm's-length contract. MPC then transferred the "Heavy Sour" oil to Exxon Company, U.S.A. (Exxon), in exchange for a higher priced "Sweet" oil, under an arm's-length contract (MPC Contract No. 2915 (Contract), dated Apr. 23, 1986). Because of the difference in the value of the oil, MPC paid a "differential." That differential was, however, reduced by the cost incurred by MPC to gather and transport the oil to Exxon's pipeline facilities at Silver Tip, Montana, as set forth in section 4 of the Contract:

> DIFFERENTIALS: Barrel-for-barrel exchange. Marathon [MPC] to pay Exxon a net differential of $2.70 per barrel. Differential is based on $3.20 base differential to be paid by Marathon [MPC] and a $0.50 per barrel average transportation differential from the field to Silver Tip, [Montana,] due [MPC] by Exxon for the Wyoming Sour crude.

(Exhibit A attached to Contract at 1 (emphasis added).) Marathon ultimately paid royalty on the sales price received under its contract with MPC, but did not pay any royalty on the transportation differential received by MPC.

By letter dated June 24, 1991, LACO requested Marathon to document how the transportation differential was computed, and show whether any part of the differential related to reimbursement for gathering costs incurred by MPC. Marathon responded on August 20, 1991, explaining that the transportation differential covered all of the costs MPC incurred to deliver its oil to Exxon, including gathering costs.

Because Marathon had failed to show what part of the differential related to gathering costs, LACO concluded that the entire differential represented the gathering costs incurred by MPC. It further held that this differential constituted a reimbursement to Marathon for the costs incurred by MPC in gathering the oil for delivery to Exxon, and was therefore part of the gross proceeds received by Marathon. Thus, LACO determined that Marathon had underpaid royalties in the amount of $30,908.05 during the period from March 1, 1986, through May 31, 1987. Marathon appealed LACO's January 14, 1992, Order to the Director, MMS.

The Associate Director, MMS, denied Marathon's appeal, concluding that the costs incurred by MPC to gather and transport Marathon's crude oil to Exxon was a necessary part of marketing the oil. She further concluded that, due to the affiliated relationship between Marathon and MPC, the reimbursements were effectively received by Marathon, and therefore constituted part of the gross proceeds accruing to Marathon from the sale of its oil.

However, the Associate Director modified the Order to permit Marathon to deduct any portion of the reimbursements paid to MPC which it could show were for transportation or other nonroyalty bearing purposes. Absent such

a demonstration, she stated that "the presumption is that the entire reimbursement is part of the Marathon's gross proceeds for production from the lease and is royalty-bearing." (Decision at 14.) Further, the Associate Director upheld LACO's requirement to perform restructured accounting.

On appeal to the Board, Appellant argues that "[t]he oil gathering charges which the MMS seeks to collect royalties on were paid by Exxon * * * to [MPC], therefore, Marathon, as lessee, did not receive any value in the form of a gathering charge reimbursement." (Notice of Appeal at 1.) Marathon asserts that it properly computed royalties on the basis of the sales price received from its purchaser, MPC, especially since this price agreed with posted prices for like-quality oil in the field where the leased lands are situated. Further, Marathon asserts that because Exxon made the differential payments to MPC in a lump sum, no specific amount of those payments can be attributed to gathering charge reimbursements.

In its Answer, MMS asserts that Federal lessees have long been required to put their production into marketable condition at no cost to the Federal lessor, an obligation which a lessee must undertake at its own expense and without deducting from royalties owed. In support of the proposition that reimbursements to a Federal lessee of gathering expenses must be included in gross proceeds, and are subject to royalty assessment, MMS relies on Mesa Operating Limited Partnership v. Department of the Interior, 931 F.2d 318 (5th Cir. 1991), cert. denied, 502 U.S. 1058 (1992).

MMS also asserts that Marathon's responsibility to place oil in marketable condition cannot be avoided by transferring the gathering duty to an affiliate, nor can gathering expenses be deducted from the royalty obligation by "paying a third party to perform these functions, or by the lessee accepting a reduced price and allowing the purchaser to incur the costs." (Answer at 8.) MMS cites Bailey D. Gothard, 144 IBLA 17, 22 (1998) to assert that the marketable condition rule applies to gathering costs even in an arm's-length purchase when a lessee accepts a reduced price that reflects services performed by the purchaser.

MMS also disputes Marathon's assertion that the subject oil was marketable before it was gathered, and notes that the differential paid to affiliate MPC indicates that MPC undertook the expenses of gathering Marathon's oil production. Finally, MMS argues that the restructured accounting order issued to Marathon is valid because the barrel for barrel exchange agreement entered into by MPC and Exxon applied to the production from over 100 Federal leases on units specifically named in the order. MMS asserts that when it sampled some of the leases on those units, it identified a systemic deficiency in royalty computations which affected the royalty computations of the remaining leases as well.

[1] Section 17(b) of the Mineral Leasing Act, as amended, 30 U.S.C. § 226(b) (1994), requires the payment of royalty based on the "amount or value of the production removed or sold from [a Federal oil and gas]

lease." MMS is afforded "considerable latitude" in determining the value of oil produced for royalty purposes. Hoover & Bracken Energies, Inc., 52 IBLA 27, 33 (1981), rev'd, Hoover & Bracken Energies, Inc. v. U.S. Department of the Interior, No. 81-461-T (W.D. Okla. Nov. 18, 1981), rev'd, 723 F.2d 1488 (10th Cir. 1983), cert. denied, 469 U.S. 821 (1984).

During the first part of the relevant time period, the applicable regulation, 30 C.F.R. § 206.103 (1986), provided that the value of production

> shall be the estimated reasonable value of the product as determined by [MMS] due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary.

(Emphasis added.) Though the onshore royalty regulations were amended effective March 1, 1989, the emphasized portion of the above regulation was reiterated in 30 C.F.R. § 206.102(h).

It is well-settled that a Federal oil and gas lessee is required to bear the costs of placing the oil in a marketable condition, including the costs of gathering. See California Co. v. Udall, 296 F.2d 384, 387 (D.C. Cir. 1961); Placid Oil Co., 70 I.D. 438, 440 (1963), and cases cited. Further, the Board has consistently found that such lessee may not avoid its royalty obligation by delegating its responsibilities to place lease production in marketable condition to an affiliate, by paying a third party to perform such functions, or by accepting a reduced price from a purchaser who is willing to incur additional costs. See Branch Oil and Gas Co., 143 IBLA 204, 206 (1998); Branch Oil and Gas Co., 144 IBLA 304, 306 (1998); and Anson Co., 145 IBLA 221, 225 (1998). The lessee's obligation to put lease production into marketable condition also applies to transactions at arm's length with a purchaser who pays a reduced price based upon providing services that put the lease production in marketable condition. Bailey D. Gothard, supra at 22. These offsets and reimbursements are included in the gross proceeds received by the producer from the sale of the lease production, and are included in the value of the oil for royalty purposes.

Although Marathon sold its crude oil to MPC, royalty is properly computed on the gross proceeds received by MPC on the subsequent sale to Exxon where the sale to MPC, an affiliate of Marathon, was not an arm's-length transaction. In Santa Fe Energy Products Co., 127 IBLA 265, 268 (1993), the Board found that the obligation to report gross proceeds accruing to

the lessee cannot be avoided by an interaffiliate transfer made in contemplation of a later sale to third parties.

In the instant case, the purchaser (MPC) gathered the oil and transported it to market and received its reimbursement for the costs it incurred, not from the producer (Marathon), but from the final purchaser (Exxon), by virtue of a reduction in the differential it was otherwise required to pay. Nevertheless, we conclude that, regardless of who made the reimbursement, it should be included in the value of the oil for royalty purposes because the costs to gather and transport the oil cannot be borne by the United States. Further, because of the nonarm's-length nature of the transaction between Marathon and MPC, that reimbursement was effectively received by MPC and, in turn, by Marathon. Thus, we agree with MMS that the gathering cost reimbursement should be considered part of the gross proceeds received by Marathon on the sale of its crude oil, and should be added to the value of the oil for royalty purposes.

Marathon has also challenged LACO's requirement, affirmed by the Associate Director, that it perform a restructured accounting. It asserts that this is a "self-audit," which MMS lacks the authority to order. We find Marathon's argument to be without merit and observe that it is well settled that MMS has the authority to order a restructured accounting. See Texaco Inc., 138 IBLA 202, 205 (1997); Phillips Petroleum Co. v. Lujan, 963 F.2d 1380 (10th Cir. 1992).

As to Appellant's assertion that gathering costs cannot be separated from the lump sum differential payments, the inability of Appellant to identify gathering costs must operate to the advantage of the Federal Government, not Appellant. Otherwise, the value of production for computing royalty would be less than the gross proceeds, in violation of 30 C.F.R. § 206.103 (1986) and 30 C.F.R. § 206.102(h). Therefore, the Associate Director properly concluded that in the absence of Marathon's identification of the gathering costs, the total differential will be added to Marathon's gross proceeds.

Finally, Marathon requests a hearing and oral argument. While the Board has discretion under 43 C.F.R. § 4.415 to order a hearing, we decline to do so in this case because it has not been shown that disposition of the case hinges on the resolution of a material issue of fact. See Woods Petroleum Co., 86 IBLA 46, 55 (1985). We also decline to order oral argument under 43 C.F.R. § 4.25 because it has not been shown that oral argument will benefit resolution of this appeal. Thus, Appellant's requests for a hearing and oral argument are denied.

We therefore conclude that the Associate Director's February 28, 1995, decision denying Marathon's appeal but modifying LACO's January 14, 1992, Order was appropriate and must be affirmed. To the extent Appellant has raised arguments which we have not specifically addressed herein, they have been considered and rejected.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 C.F.R. § 4.1, the decision appealed from is affirmed.

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John H. Kelly
Administrative Judge

I concur:

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David L. Hughes
Administrative Judge